leum products. This type of tax was the topic of much discussion during the deliberations over the budget resolution for fiscal year 1986. An oil import fee of $5 per barrel would raise about $7 billion per year. About one-quarter of that amount would come from higher oil windfall profit taxes, since an import fee would allow the price of all domestically produced oil to increase, thereby increasing the windfall "profit" and tax on each barrel.

An oil import fee, like a tax on all oil, would serve to maintain conservation incentives by holding up the price for all imported and domestically produced energy sources. Moreover, an oil import fee could be an appropriate source of revenue for the Strategic Petroleum Reserve, insofar as the Reserve is designed to reduce the potential consequences of oil supply interruptions. Unlike a tax on all oil, however, an oil import fee would provide an incentive to increase domestic production of oil, because the fee would raise the profitability of domestic production. These effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased as U.S. energy sources were depleted faster.

With the spot price of oil currently under $20 per barrel, the $5 fee would still leave the total price of oil well below its $35-per-barrel price in 1981. Furthermore, if there were excess supplies of crude oil on the world market when the fee was enacted, part of the fee would be borne by foreign suppliers. One consequence of this is that an oil import fee might cause political problems with some important U.S. trading partners (though others would benefit from a fall in the world oil price). Attempts to mitigate these problems, however, by exempting imports from selected countries such as Canada, Mexico, and the United Kingdom would substantially reduce the fee's revenue potential.

Impose Excise Tax on Natural Gas. Price controls on most domestically produced natural gas were lifted on January 1, 1985, under the terms of the Natural Gas Policy Act of 1978 (NGPA), but an estimated 35 percent to 40 percent will remain regulated and subject to price controls. The average wellhead price for all gas is about $2.60 per 1,000 cubic feet, but is $1.40 for price-controlled gas. Economists generally agree that price controls lead to an inefficient allocation of natural gas. Below-market prices for some categories of gas will tend to make producers shift their production from controlled to decontrolled gas. To the extent that decontrolled gas is more costly to produce, resources are wasted from these production shifts. In addition, below-market prices encourage some consumers to use more gas than they would otherwise.

The current misallocations in the natural gas market could be substantially reduced if all gas were decontrolled. Full decontrol of all natural gas,

however, could result in large windfall profits for producers of gas still under price controls. The Congress might want to tax this windfall as it did that on oil. One version of such a tax could raise $5 billion in the first full year. To the extent that windfall profits from the decontrol of gas were temporary, such a tax would provide only a short-term reduction in the deficit. Moreover, taxing the profits of gas producers could reduce any potential gain from decontrol by significantly reducing the incentive for companies to reallocate their production toward the least expensive supply sources.

An alternative that would raise revenue on a long-term basis would be a simple excise tax on natural gas, unrelated to any calculation of windfall profits. An excise tax of $1.00 per 1,000 cubic feet, for example, would raise about $13 billion annually. The current price of residential natural gas is about $7.00 per 1,000 cubic feet, so that if the tax was fully passed on to consumers, the price rise would be about 14 percent. Such an excise tax would encourage conservation of gas or conversion to oil, coal, or other fuels. To the extent that gas users shifted to oil, however, dependence on imports could increase. Moreover, while switching to coal would avoid increasing oil consumption, it might impose additional environmental costs. Therefore, a tax on natural gas alone might not be consistent with other energy policy goals. This inconsistency might be avoided by simultaneously taxing other energy sources, as well as natural gas.

Impose Additional Motor Fuel Excise Tax and Allocate Revenues to General Fund. The present federal tax on gasoline and other highway motor fuels is 9 cents per gallon. The revenue from this tax is earmarked for construction and improvement of highways, bridges, and mass transit facilities. State governments also impose gasoline taxes ranging from 7 cents to 18 cents per gallon. Compared with other countries, many of which levy taxes of well over $1.00 a gallon, the United States charges one of the lowest tax rates on motor fuel in the world.

An additional federal excise tax on motor fuels would raise about $0.9 billion per year for each cent per gallon of tax. If the tax was used to expand transportation outlays through the highway trust fund, it would not reduce the deficit; instead, this estimate assumes the proceeds would be allocated to the general fund. Because the average national price of gasoline has dropped from a peak of about $1.39 a gallon in March 1981 to about $1.20 in December 1985 (with further declines expected), an additional tax of 12 cents per gallon would not put the total cost of gasoline above what consumers have already experienced.

Beyond raising revenue, an additional excise tax on motor fuel would reduce consumption of gasoline and diesel fuel and dependence on foreign oil by encouraging people to drive fewer miles or purchase more fuel-efficient cars and trucks. The excise tax would probably not significantly affect oil consumption for other purposes, such as electricity production or home heating. Arguments against such a tax are that it would impose an unfair burden on people who commute long distances by car, compared with other users of energy, and that it would be regressive. The regressiveness of the tax, however, might be offset by small adjustments in income tax rates or by providing energy stamps for low-income people.

Impose Broad-Based Tax on All Energy. Instead of placing selective excise taxes on various types of energy, the Congress could impose a broad-based tax on all forms of energy consumption. This tax would apply to most energy sources and cover both domestic and foreign suppliers. A national energy tax would heighten conservation incentives and reduce consumption of all forms of energy. It would probably neither decrease oil consumption as much as an oil import fee or oil excise tax of equal revenue, nor provide significant incentives for consumers to switch to forms of energy other than oil. A 5 percent tax on the value of all domestic and imported energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise over $15 billion per year in revenues. Further, because the tax would apply to all energy sources, it could raise much more revenue at a lower rate than through selective taxes.

A national energy tax could be based either on units produced (such as barrels of oil, tons of coal, or cubic feet of gas) or on the heat content--in British thermal units--of the fuel (Btu tax). Depending on how the tax was structured, the relative prices of the various forms of energy could either be left unchanged or substantially altered. For example, because a dollar's worth of coal currently buys more Btus, a uniform Btu tax would raise the price of coal by a larger percentage than that of oil or natural gas. (Coal sells for about one-quarter of the price of oil per Btu.) A national tax on energy could be collected either from producers and importers, or from wholesalers.

REV-06 INCREASE EXCISE TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Extend DEFRA Increase of Telephone Excise Tax	0.0	1.3	2.3	2.5	2.7	8.8
Raise the Cigarette Excise Tax to 32 Cents per Pack	3.5	5.1	5.1	5.1	5.1	23.8
Increase Excise Taxes on Distilled Spirits	0.5	0.7	0.7	0.7	0.7	3.5
Raise Excise Taxes on Beer and Wine to Rate on Distilled Spirits	5.7	6.2	6.3	6.4	6.5	31.1
Index Current Cigarette and Alcohol Excise Tax Rates for Inflation	0.3	0.4	0.6	0.8	1.1	3.2

Additional revenues could be raised by extending the temporary increases in the tobacco and telephone excise taxes that were imposed in recent tax legislation, and by increasing alcohol excise taxes.

Extend DEFRA Increase of Telephone Excise Tax. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised the excise tax on local and long-distance telephone service and teletypewriter exchange service to 3 percent for calendar years 1983 through 1985. The Deficit Reduction Act of 1984 (DEFRA) extended the 3 percent rate through calendar year 1987. Extending the tax beyond 1987 at the 3 percent rate would raise net revenues by about $9 billion over fiscal years 1988-1991.

Arguments for extending the tax are that it is a broad-based tax, since virtually all households have telephones, and that the cost to the government of administering the tax is low. Arguments against extension

are that the tax is arbitrary, burdening households in proportion to their use of telephone services rather than income or some other standard of fairness; that it may limit expansion and innovation in the telecommunications industry; and that it is regressive if it is not offset by other changes in the tax structure.

Increase the Cigarette Excise Tax. TEFRA increased the excise tax on cigarettes from 8 cents per pack to 16 cents for the period from January 1, 1983, to September 30, 1985. The 16-cent rate was subsequently extended through March 15, 1986. (The President's budget assumes the 16-cent rate will be made permanent by the Congress; the CBO baseline forecast assumes it will expire as scheduled on March 15, 1986.) The 16-cent federal tax represents under 20 percent of the current average market price (including tax) per pack, significantly less than the 42 percent of the price that the 8-cent tax represented when it was set in 1951. Making the 16-cent rate permanent would add about $9 billion to federal revenues (net of reduced income taxes) between 1987 and 1991. Extending the 16-cent rate through fiscal year 1986 and then increasing the tax to 32 cents per pack on October 1, 1986, would raise about $24 billion (net of reduced income taxes) between 1987 and 1991.

An increase in the cigarette tax could be seen as compensation for those costs of smoking not included in the price received by sellers, such as medical costs, that society in general ultimately bears. In that sense, it would improve horizontal equity by making smokers confront the full social costs of smoking. An increase might also discourage smoking to a limited degree by raising prices, which would probably have its greatest impact on the young, thereby resulting in long-run improvements in health. On the other hand, if the increase exceeded any net costs imposed on other taxpayers by smokers, it could be regarded as discriminatory against smokers (about one-third of the population) and also objected to as regressive. (The regressiveness of the tax, however, could be offset by relatively small changes in the structure of income tax rates.) Finally, increases in the federal cigarette tax would have an adverse effect on state and local revenues from cigarette taxes and in many states would merely substitute for a planned state increase in cigarette taxes.

Increase Taxes on Alcoholic Beverages. The tax on distilled spirits was increased by DEFRA to $12.50 per proof gallon effective October 1, 1985. This marks the first increase in the tax rate on distilled spirits since 1951 when it was set at $10.50 per proof gallon. In 1951, $10.50 per proof gallon represented 43 percent of the average product price; by comparison, $12.50 per proof gallon represents 27 percent of the average current price. Increasing the tax to $15.00 per proof gallon on October 1, 1986, would raise

$3.5 billion in revenues (net of reduced income taxes) over the 1987-1991 period and still leave the tax as a percentage of average product price below that in effect in 1951. The increase in tax to $15.00 would represent roughly a 5 percent increase in the price of a typical bottle of bourbon.

Nondistilled beverages--beer and wine--were unaffected by DEFRA and are thus still taxed at the per-unit rates in effect since 1951. Moreover, beer and (especially) wine are currently taxed significantly more lightly than distilled spirits relative to both value and alcohol content. Increasing the tax rates on beer and wine to the alcohol-equivalent rate of the current tax rate on distilled spirits, effective October 1, 1986, would raise about $31 billion between 1987 and 1991. The tax on a fifth of wine, with 12 percent alcohol content, would increase by 57 cents, from 3 cents to 60 cents, and the tax on a six-pack of beer would increase by 49 cents, from 16 cents to 65 cents.

As with cigarette taxes, increased taxes on alcoholic beverages would bring the tax rates more into line with historical rates, and would help to offset the social costs of drinking (such as those from alcoholism and alcohol-related automobile accidents). On the other hand, some critics might argue that increases would make tax rates on alcoholic beverages unjustifiably high compared with the costs imposed on others by most alcohol users. In addition, as with cigarette taxes, increases may be objected to as regressive (to the extent they are not considered user charges); and increases in the federal tax rates would interfere with a tax base tapped by the states.

Index Cigarette and Alcohol Tax Rates for Inflation. When taxes are set on a per-unit basis, the tax as a percentage of value will fall as inflation boosts the value of the taxed product. As a result, inflation reduces the real burden of unit taxes over time. Indexing tax rates to the Consumer Price Index would insure that tax revenues kept pace with inflation. Indexing current cigarette and alcohol tax rates to changes in the CPI after October 1, 1986, would raise about $3 billion in net revenues over the 1987-1991 period.

Indexing of specific excise taxes would prevent inflation-induced erosion of tax receipts in a gradual and predictable manner, thereby reducing the impact of abrupt increases in unit rates on consumers, state and local governments, and businesses. On the other hand, to the extent excise taxes are regarded as inferior to income or general sales taxes as a way to raise revenue, failure to index them is one way to allow their relative burden to decline over time.

An alternative to indexing would be to convert the unit taxes to *ad valorem* taxes (set as a percentage of value); this would accomplish the same objective of tying tax revenues to price increases, although revenue would be tied to the prices of the taxed goods, not the general price level. *Ad valorem* taxes would, however, be administratively more complex because of the need to impute manufacturers' prices when the goods are sold by manufacturer-controlled wholesalers and retail outlets.

REV-07 REVISE DEPRECIATION RULES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
H.R. 3838	13.0	27.3	38.9	53.2	75.9	208.3
President's Tax Reform Proposal	12.4	24.2	32.4	43.9	53.1	166.0

NOTE: These revenue estimates are based on new depreciation systems as explained in the text. The estimates include a repeal of the investment tax credit. Both options are estimated on the basis of the current set of tax rates, not the lower rates proposed by the President and the House.

Under current law, capital assets are depreciated under schedules provided for by the Accelerated Cost Recovery System (ACRS). This system assigns each asset to one of five groups: most machinery and equipment are assigned to the three- or the five-year depreciation class; most public utility property is placed in the 10- or 15-year public utility class; and most buildings are assigned to the 19-year real property class. Equipment and machinery, but not buildings, are also eligible for the investment tax credit (ITC): assets in the three-year class qualify for a 6 percent credit; assets in the five-year and public utility classes qualify for a 10 percent credit.

This capital recovery system (consisting of the combination of ACRS and the investment tax credit) has been criticized because it favors some assets over others and because it facilitates tax shelter activities. Specifically, some critics charge that, because effective tax rates on different classes vary widely, investment decisions are driven by tax considerations and not strictly by the market, thereby resulting in an inefficient allocation of scarce capital. The table below, which shows effective corporate tax rates for several types of assets, indicates that current law significantly favors equipment over structures by taxing them at much lower effective rates.

Another line of criticism notes that taxes on the return both to machinery and equipment and to buildings are lower than taxes on ordinary income because of the acceleration of depreciation deductions. This en-

EFFECTIVE CORPORATE TAX RATES ON ASSETS

Asset Class	ACRS (years)	Real Effective Tax Rates (In percents) Current Law	ACRS No ITC	ACRS Full Basis Adjustment a/	H.R. 3838 b/	President's Proposal b/
Automobiles	3	-12.6	38.1	4.0	42.6	24.4
Computers	5	-8.5	48.7	10.8	38.5	26.8
Heavy Trucks	5	-8.0	47.2	10.2	37.1	25.7
Aircraft	5	-6.1	41.0	8.1	47.8	26.7
General Industrial Equipment	5	-4.5	34.2	6.2	46.1	27.7
Furniture and Fixtures	5	-4.2	32.6	5.8	39.0	20.3
Communication Equipment	5	-4.4	33.7	6.1	40.1	27.1
Ships and Barges	5	-3.3	27.8	4.7	42.4	27.4
Engines and Turbines	10	18.3	39.5	22.7	51.1	27.9
Electric Light and Power	15	16.0	31.9	18.9	42.9	20.1
Telephone Plant	15	16.5	32.7	19.4	43.8	20.6
Industrial Buildings	19	38.2	38.2	38.2	48.8	40.5
Commercial Buildings	19	35.3	35.3	35.3	45.7	37.5

SOURCE: Congressional Budget Office.

NOTE: Taxes are computed under the assumptions of 100 percent equity financing, a 4 percent expected inflation rate, and a real rate of return of 6 percent net of the corporate taxes. The taxpayer is a corporation with a statutory marginal tax rate of 46 percent. Taxes paid by individual shareholders on dividends and capital gains are not counted in the calculation; the tax rate is the corporate-level tax only.

Economic depreciation rates used in the calculation of these tax rates are reported in Charles R. Hulten and Frank C. Wykoff, "The Measurement of Economic Depreciation," in Charles R. Hulten, ed., *Depreciation, Inflation, and the Taxation of Income From Capital* (Washington, D.C.: The Urban Institute, 1981), p. 95.

a. For a discussion of the full basis adjustment, see REV-09.

b. Assumes a statutory tax rate of 46 percent.

courages the formation of tax shelters in real estate and equipment leasing. These tax shelter investments are often carried out by limited partnerships that create artificial tax losses for individuals through the combination of accelerated depreciation, interest deductions, and capital gains taxation of the proceeds of real estate sales.

One way to ameliorate these problems would be to eliminate the investment tax credit and alter depreciation rules so that depreciation deductions more closely resembled actual depreciation. Changes in depreciation rules to meet these objectives could be accomplished in a variety of ways. One option would be the depreciation system in H.R. 3838. Under such a system, assets would be grouped into 10 classes, depending on their useful lives. For machinery and equipment, this determination would be made according to an asset's ADR midpoint life. (The ADR midpoint life is the midpoint of an asset's depreciable life under the Asset Depreciation Range System--the depreciation system that existed prior to the Economic Recovery Tax Act of 1981.) Real property would be placed in the highest ADR class.

Under the depreciation system in H.R. 3838, assets would be assigned the following class lives:

ADR Midpoint (years)	Recovery Life Under Proposal
Less than 5	3
5 to 6.5	5
7 to 9.5	7
10 to 12.5	10
13 to 15.5	13
16 to 19.5	16
20 to 24.5	20
25 to 29.5	25
30 to 35.5	30
36+ and real property	30

The depreciation rate would be determined by use of the 200 percent declining balance method except for the longest-lived assets, which would be depreciated using straight-line only.

A revision of the depreciation system to approximate economic depreciation would improve the allocation of capital among users by reducing

disparities in effective tax rates among assets, and would reduce incentives to engage in tax shelter activities. The tax rates in the table above show that the tax system would be much more neutral among different types of assets under H.R. 3838 than under ACRS with the investment tax credit. In addition, it would reduce discrimination against firms and industries (primarily firms suffering temporary losses, and start-up firms or firms with extraordinarily large capital expansion programs) that are unable to make full use of existing incentives because they lack the income or taxes from past investments required to offset newly earned deductions and credits. At current tax rates, this proposal would raise about $13 billion in 1987 and $208 billion over the 1987-1991 period.

If not accompanied by other provisions, however, such as lower corporate tax rates or relief of double taxation of corporate income, any lengthening of depreciation periods or reduction in investment credits would increase the taxation of capital income and could reduce overall business investment. Furthermore, increasing the taxation of business capital would widen the distortion that favors housing and consumer durables (currently untaxed), thereby shifting more capital into the household sector. This increased distortion could offset the improvement in efficiency resulting from the evening of tax rates. Thus, Congress may want a depreciation system that continues to encourage business investment, but in a more neutral fashion than current law.

One proposal that would maintain an effective tax rate below the statutory corporate rate, thereby continuing to subsidize domestic plant and machinery, is the depreciation system embodied in the President's tax reform proposal. This system, referred to as the Capital Cost Recovery System (CCRS), would consist of six classes of assets with tax lives somewhat longer than are now used under ACRS. (Depreciable lives would range from 4 years for short-lived property to 28 years for long-lived property.) Depreciation allowances would, however, be indexed for inflation and would be more generous than current allowances except at very low rates of inflation. Depreciation allowances would also be more generous under CCRS than those in H.R. 3838 because the latter does not provide any indexation. As with H.R. 3838, the President's proposal would eliminate the investment tax credit.

The effective tax rates under CCRS shown in the table (the President's proposal) indicate that the rates on machinery and equipment are substantially above current law rates, but well below those under H.R. 3838. (They are also below those under ACRS, excluding the ITC.) The tax rates under CCRS are generally in the neighborhood of 20 percent to 27 percent, compared with a statutory rate of 46 percent. The effective tax rates on

commercial and industrial buildings under CCRS, however, are somewhat higher than under current law, but remain below the statutory rate. Overall, CCRS would reduce (but not eliminate) the disparities that now exist in taxation of machinery and equipment versus buildings and structures, and could thereby improve the allocation of business capital. These calculations indicate that CCRS would retain a substantial incentive for machinery and equipment, but would not be nearly as generous as present law. At current tax rates, this proposal would raise about $12 billion in 1987 and $166 billion over the 1987-1991 period.

REV-08 MATCH INCOME WITH EXPENSE FOR MULTIPERIOD CONSTRUCTION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	2.4	8.2	12.4	10.2	7.5	40.8

In general, taxpayers are required to calculate their taxes on an annual basis, which requires assigning all expenses and revenues to a tax year. Where the production of goods and services involves a long time between the start of production and the receipt of payment, rules are needed to allocate revenues and costs across several years. For example, the interval between the start of construction of a nuclear aircraft carrier and its final delivery to the U.S. government may be five years.

Accounting Method for Long-Term Contracts. Under current law, taxpayers can use either the "percentage of completion" or the "completed contract" method of accounting for income and expense related to long-term contracts. The percentage of completion method allows taxpayers to deduct all contract costs on a current basis, but also requires them to include as income that percentage of the contract price that those costs represent, even if no cash has changed hands. For example, if 10 percent of a contract is completed in a given year, 10 percent of the contract's final price is allocated as income for that year. This rule results in a fairly accurate annual measure of income since it requires firms to match costs with their associated income on an annual basis.

In contrast, under the completed contract method, gross income and deductions for most costs are deferred until the contract is completed. In general, the completed contract rules are more favorable to taxpayers than the percentage of completion rules because not all deductions for costs associated with the completion of a contract must be deferred--some costs may still be deducted currently--even though all receipts are deferred.

For contracts over two years in length, certain indirect costs may now be deducted currently. These include such items as marketing expenses, interest, and bidding expenses for contracts not awarded the contractor (see proposed Treasury Regulation 1.451-3). Perhaps the most

important of these current deductions is that for interest. This allows contractors to borrow during the construction period, deduct the interest on a current basis, but defer the recognition of the associated income until the contract is completed. The rules for contracts of less than two years (three years for small contractors) are more lenient. In addition to the items above, certain other indirect contract costs are also allowed as current deductions. The preferences for longer-term contracts, though not as large, provide more subsidy than those for short-term contracts because the size of the tax benefit increases with a longer potential deferral.

Placing all multiperiod contracts on the percentage of completion basis would result in a more accurate annual measure of income. All expenses would be deductible on a current basis, and income would be recognized over time as the contract was completed.

Construction Period Interest. Under current law, interest related to self-constructed real property (that is, property constructed by the taxpayer for the taxpayer's own use) must be capitalized and amortized over 10 years. Interest related to the construction of all other tangible property (whether self-constructed or not) is allowed as a current deduction. For example, interest paid during the construction of heavy-duty machinery is currently deductible.

Requiring capitalization of interest on all long-lived self-constructed personal property (and real property) used in the taxpayer's trade or business (or for any activity for profit) and for all property (produced for sale by contractors) that required more than two years to produce would match interest deductions with the income the associated costs generate. Under this proposal, contractors using the completed contract method of accounting would be required to capitalize construction period interest for construction contracts over two years in length; those required to use the percentage of completion method would still be able to deduct interest on a current basis.

H.R. 3838 would require the percentage of completion method for multiperiod contracts (except for small contractors) and capitalizing construction period interest, as described above. This would raise about $2 billion in 1987, and $40 billion over five years. In contrast, the President's tax reform proposal would retain the completed contract rules, but would extend the capitalization rules for contracts of over two years to all multiyear contracts. Some contract costs would, however, remain currently deductible.

Proponents of these accounting rules (for contracts and for construction period interest) argue that they result in a more accurate measure of a taxpayer's income. They argue that costs should be matched against the income they produce; if not, opportunities for deducting current expenses and deferring income recognition can result in substantial tax avoidance. In the case of long-term contracts, this argument implies that deductions should not be allowed until income is recognized. Similarly, for self-constructed assets this implies that all costs (including interest) necessary to the production of an asset should not be deducted until that asset is placed in service and depreciated or otherwise disposed of.

Opponents of these accounting proposals argue that they are administratively more complex than current law. Also, they may impose some cash flow problems on some contractors since they would require them to pay taxes before the actual receipt of cash from final purchasers. Moreover, to the extent defense and other federal contractors are adversely affected, there may be a smaller net budgetary savings if higher outlays are necessary to compensate suppliers for higher tax payments.

REV-09 ELIMINATE INVESTMENT TAX CREDIT OR REQUIRE FULL BASIS ADJUSTMENT

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Eliminate Credit	12.1	25.0	30.9	35.7	41.2	144.9
Require Full Basis Adjustment	0.4	1.6	3.1	4.7	6.2	16.0

Under current law, taxpayers are allowed tax credits for business investments in personal property (mostly machinery and equipment). The investment credit for property with a five-year life (which includes most machinery and equipment investment) is 10 percent, while the investment credit for three-year property (mainly R&D equipment, lightweight motor vehicles, and special tools) is 6 percent. Firms are required to reduce their depreciation allowances by 50 percent of the investment tax credit; this is referred to as a 50 percent "basis" adjustment. Thus, for property receiving a 10 percent credit, firms can depreciate 95 percent of its cost (although they have effectively paid only 90 percent); for property receiving a 6 percent credit, firms can depreciate 97 percent of its cost.

For three- and five-year property, the combination of the investment tax credit and current depreciation rules is about equivalent to an immediate write-off in present-value terms (assuming a 10 percent discount rate). This implies that the expected corporate tax rate on income from new three- and five-year property is about zero. In contrast, the combination of the investment tax credit and the Accelerated Cost Recovery System (ACRS) for 10- and 15-year public utility property and commercial and industrial buildings is much less generous. (Although public utility property is eligible for the investment tax credit, commercial and industrial structures are not.) Thus, the expected corporate tax rate on income from public utility property is about 15 percent and from commercial and industrial structures about 35 percent. (See the effective tax rate table in REV-07.)

Two alternatives for narrowing the disparity in effective tax rates among assets would be to require a full (100 percent) basis adjustment for the credit or to repeal the credit altogether. (The full basis adjustment would require firms to reduce their depreciation allowances by the full

amount of the investment tax credit.) The full basis adjustment would raise the expected corporate tax rates on income from three- and five-year property to between 5 percent and 10 percent, depending upon the specific asset. Tax rates on income from public utility property would rise to about 20 percent; those on income from structures would remain at about 35 percent (see the effective tax rate table). Requiring the full basis adjustment would raise revenues by $0.4 billion in 1987, and $16 billion over the 1987-1991 period.

Repealing the investment tax credit would result in a further convergence in expected corporate tax rates. This change would raise tax rates on three- and five-year property to between 35 percent and 50 percent, depending on the asset. The tax rates on public utility property would rise to between 30 percent and 35 percent; tax rates on commercial and industrial buildings would remain at about 35 percent. As shown in the effective tax rate table, this option would substantially lessen the divergence in effective corporate tax rates relative to current law. Both H.R. 3838 and the President's tax reform proposal would repeal the credit. Repealing the credit for property placed in service after January 1, 1987, would raise revenues by $12 billion in 1987, and $145 billion over the 1987-1991 period. Application of more liberal transition rules, such as those in H.R. 3838, for property placed in service after the effective date could significantly reduce the revenue pickup in the first two years.

It has been argued that the current investment tax credit is necessary to encourage domestic investment in equipment and machinery, thereby increasing productivity and the international competitiveness of U.S. industry. The opposite case is that current tax law is too generous in its treatment of machinery and equipment compared with structures and inventories, and may distort decisions on investments; that is, it may lead corporations to invest too much in equipment and not enough in new plant and inventories. Requiring a full basis adjustment would partially reduce the current disparity in tax rates; repealing the credit would alleviate most of the tax distortion. (See REV-07 for changes in depreciation rules and further discussion of investment incentives.)

REV-10 REDUCE INCENTIVES FOR BUILDING REHABILITATION

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Repeal the Rehabilitation Tax Credits	0.4	1.3	1.8	2.1	2.4	8.0
Limit Credits to Historic Renovations	0.3	0.9	1.2	1.3	1.4	5.1

Current law allows large tax credits for amounts spent rehabilitating older income-producing buildings and provides rapid amortization for rehabilitating low-income housing. These measures were designed to encourage businesses to renovate their existing premises rather than relocate; encourage people to refurbish older buildings for new uses; promote the preservation of historic buildings; and increase the supply of low-income housing.

Rehabilitation tax credits range from 15 percent to 25 percent, depending on the age of the building and whether it is registered with the Department of the Interior as a historic structure. Rehabilitation of low-income housing can be amortized over a 5-year period, as opposed to the 15-year period permitted for new construction of low-income housing under the Accelerated Cost Recovery System. Repealing the rehabilitation credits would increase revenue by $8 billion over the 1987-1991 period; retaining only a 15 percent credit for certified historic renovations would save $5 billion in 1987-1991; increasing the amortization period for qualified low-income housing from 5 years to 15 years would save $0.1 billion in 1987 through 1991.

The main argument against these incentives is that they tend to divert capital from more productive uses by favoring particular investments. For example, the credits favor commercial use over most rental housing. Commercial buildings can qualify for the credit even if not in a historic district, but credits for rental housing are only available for historic buildings. In favoring renovation over new construction, the credits may encourage more costly ways of obtaining more housing and commercial buildings.

The argument for the credits is that rehabilitation of low-income housing and historic preservation may have social benefits, such as the prevention of neighborhood deterioration. The rapid amortization for low-income housing may reduce the amount of direct outlays for rent subsidy payments to poor families; the rehabilitation credit for older commercial buildings may stem the outflow of jobs from urban areas, and it discourages destruction of historically noteworthy or architecturally distinguished buildings. This latter objective, however, could be accomplished at lower cost by retaining a credit only for renovation of certified historic buildings. Preliminary surveys indicate that a 15 percent credit would be sufficient to cover the extra costs of certification and historic-quality rehabilitation. In addition, limiting the credit to historic buildings would remove the incentive to convert older rental housing to commercial use.

The President's tax reform proposal would eliminate rapid amortization for low-income housing and repeal the rehabilitation tax credits for older and historic structures. H.R. 3838 would retain rapid amortization for low-income housing, but reduce the rehabilitation tax credits to 20 percent for certified historic structures and to 10 percent for nonresidential buildings constructed before 1935.